

# The Effect of Good Corporate Governance and Environmental Performance on Financial Performance of the Proper Listed Company on Indonesia Stock Exchange

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## ABSTRACT

This research aimed to determine whether the environmental performance and Good Corporate Governance (GCG) mechanisms, such as managerial ownership, institutional ownership, the proportion of independent commissioners had effects of the audit committee on measured financial performance by using Return on Equity (ROE). This research population was manufacturing company listed on Indonesia Stock Exchange that participated in PROPER 2012/2013 and 2013/2014. Based on the multiple regression analysis, audit committee partially had a significant effect on financial performance, while the others did not. Meanwhile, the analysis result shows that environmental performance and all GCG mechanisms simultaneously have significant effects on financial performance.

**Keywords:** Good Corporate Governance, environmental performance, financial performance

## INTRODUCTION

One of the benchmarks used by stakeholders to assess the merits of a company is through financial performance. A good financial performance can encourage the interest of investors to invest in the company. Return on Equity (ROE) is the ratio used to measures a company's profitability by revealing how much profit a company generates with the money shareholders have invested. Hermuningsih (2013) found that larger ROE would result in the better financial performance of a company.

Management, as a party given the delegation of the owners of capital to operate the company, needs to be constantly monitored. Different interests owned by the owners of capital and management can lead to the

disintegration in the company. With Good Corporate Governance (GCG), the authority of all parties in the company can be arranged and the supervisory function can be optimized to reduce the occurrence of fraud committed by various parties in the company for its sake. The existence of GCG is expected to reduce conflicts of interest that may occur that impede the progress of the company's financial performance (Xu & Xia, 2012).

GCG mechanisms that can be applied are managerial ownership, institutional ownership, as well as the establishment of independent director and audit committee. Ahmed *et al.* (2013) found that internal governance mechanisms have material effects on firm performance. Managerial stock ownership and institutional ownership are considered able to reduce

the risk of abuse of authority by the management. With the contribution of share ownership, management may be motivated to do the working performance better, and also to work harder in the interests of shareholders. Arifani (2013) claimed that if something went improperly in the decision-making, and financial performance of companies did not have a good condition, the management would also get affected. Beside managerial ownership, stock ownership by other institutions is also able to improve the oversight of management to be more optimal, and to encourage the management to be more motivated because they intend to show great performance to external parties.

GCG implementation can also be done by appointment of the independent commissioner. The presence of independent commissioners coming from external parties is a form of optimization for oversight of the company to be in the balance and interests of all shareholders, majority, and minority, as well as other stakeholders (Chandra, 2010). Implementation of GCG also can be done by the establishment of an audit committee comprised of independent parties that have no interest to management. Through the independence and the ability of the audit committee in overseeing the company's activities that include conducting audits in the company, the performance of the company is expected to be more effective, transparent and accountable.

Non-financial performance such as environmental performance also has been an important concern for the stakeholders. Hana and Rahman (2013) suggested that investors chose companies that had good business ethics as well as a high concern for the environment. Indonesian government creates a program called PROPER which aims to encourage awareness of good environmental management efforts. This program is held annually. The result of the program will be announced through the official website of The Ministry of Environment and Forestry of the Republic of Indonesia.

Several studies have been conducted to determine the effect of the mechanism of corporate governance and environmental performance on the financial performance of the company such as (Cao *et al.*, 2013). Moreover Waskito (2014) found that managerial ownership had no effect on the financial performance of the company. Meanwhile, Kurlelasari (2013) and Diandono (2012) found that institutional ownership has an effect on financial performance. Then, Nugrahani and Nugroho (2010) pointed out that the proportion of independent commissioners had an impact on the financial performance of the company, while Arifani (2013) and Triwinasis (2013) found that audit committee affected company's financial performance. Beside the GCG mechanism, Suratno and Al-Tuwaijri, as cited by Pujiasih (2013), stated that environmental performance was also able to affect financial performance. In contrast, Yu *et al.* (2009) did not find a positive relationship between firm environmental performance and financial performance. The differences of the research findings

related to the influence of corporate governance and environmental performance to company's financial performance motivate researchers to do further research on this particular topic. The uniqueness of this research is the use of PROPER rating as a measurement of environmental performance.

Managerial ownership is one of the corporate governance mechanisms that aims to provide opportunities to the management to own shares of the company. Daraghma and Alsinawi (2010), and Wahla *et al.* (2012) found that managerial ownership had no effect on the financial performance of the company. With the contribution of share ownership, the ownership of the company by the management will arise, it will be motivated to work more effectively and to provide maximum performance. Management is also working more carefully and considering the risks in any decision-making because if something goes improperly, the management as one of the shareholders will also be affected. Thus, the managerial share ownership can improve management performance. Besides, it is able to push the company's improved financial performance.

H<sub>0</sub>1: Managerial ownership does not affect company's financial performance

H<sub>a</sub>1: Managerial ownership affects company's financial performance

Sabrinna and Adiwibowo (2010), Kohl and Schaefer (2012) and Larcker *et al.* (2007) suggested that the higher the institutional ownership was, the better the company's performance was. This is due to the other institutions that improve the oversight of corporate performance. Share ownership by other institutions reduces the potential for management to commit fraud or do things that are selfish. Besides, institutional ownership also encourages companies to be more careful and considering better with every decision (Leung & Cheng, 2013). Manafi *et al.* (2015) and Fazlzadeh *et al.* (2011) found that stock ownership by the institutional party had an influence on the financial performance of the company.

H<sub>0</sub>2: Institutional ownership does not affect company's financial performance

H<sub>a</sub>2: Institutional ownership affects company's financial performance

According to Kumaat (2013), independent commissioners have a positive influence on the financial performance of the company. The optimal supervision through the presence of independent commissioners is expected to maintain objectivity in the company so that the company's performance can be more effective, and the company's financial performance can be increasing.

H<sub>0</sub>3: Proportion of independent commissioners does not affect company's financial performance

H<sub>a</sub>3: Proportion of independent commissioners affects company's financial performance

Alijoyo, as cited by Priantana and Yustian (2011), stated that audit committee in aiding the commissioners in ensuring the effectiveness of the internal control system, and also internal and external audit assignments was expected to optimize the monitoring of the performance of the company. The expertise of audit committee member had a positive association with financial reporting quality (Krishnan *et al.*, 2011). With audit committee, transparency and corporate accountability monitored properly. In, addition, the associated risks of fraud in the audit process and abuse of the company's financial statements can be minimized so that the performance of the company can be more effective, and increasing company's financial performance (Brennan & Kirwan, 2015). Next, Amba (2014) found that the presence of audit committee had a positive influence on the financial performance of the company.

H<sub>0</sub>4: Audit committee does not affect company's financial performance

H<sub>a</sub>4: Audit committee affects company's financial performance

According to Tjahjono (2013) and Titisari and Alviana (2012), environmental performance as one of the concerns of investors and other stakeholders, has an influence on the financial performance of the company. Good environmental performance shows that the companies has a good business ethics as well as contributes to sustainable development (Herbohn *et al.*, 2014). The companies that take responsibility for the environment would obtain a positive image in the eyes of the public, including consumers and investors so that investment and consumption in the company increase.

H<sub>0</sub>5: Environmental performance does not affect company's financial performance

H<sub>a</sub>5: Environmental performance affects company's financial performance

## METHODS

The object used in this research is manufacturing companies listed in Indonesia Stock Exchange and PROPER in period 2012/2013 and 2013/2014. Selection of the sample uses purposive sampling method with the following criteria: (1) the manufacturing company listed on Indonesia stock exchange in 2014; (2) the company that has been listed before 2012, but has not experienced relisting or delisting during 2012-2014; (3) the company is a participant of proper 2012/2013 and 2013/2014; (4) the company has a complete annual report and financial report for the years of 2013-2014; (5) financial report is presented on an annual basis (12 months); (6) the company has not experienced a loss (net loss) for the years of 2013-2014. Based on the selection of the sample, there are 25 companies with two years of total research so that the number of samples is 50. This research uses five independent

variables as following:

Managerial ownership =

$$\frac{\text{Number of Management's Shares}}{\text{Number of Shares Outstanding}} \quad (1)$$

Institutional ownership =

$$\frac{\text{Number of Institutional's Shares}}{\text{Number of Shares Outstanding}} \quad (2)$$

Porportion of Independent Commissioner =

$$\frac{\text{Number of Independent Commissioner}}{\text{Total Commissioner}} \quad (3)$$

Audit Committee =

$$\text{Number of Audit Committee Members} \quad (4)$$

Environmental performance is an assessment of the extent to which the company can perform environmental management. Environmental performance is measured by PROPER ranking. 'Gold' rank is given to a value of 5, 'Green' rank is given to a value of 4, 'Blue' rank is a value of 3, 'Red' rank is for a value of 2, and a 'Black' rank is a value of 1.

The dependent variable used in this research is the company's financial performance as measured by Return on Equity (ROE).

$$\text{ROE} = \frac{\text{Net Income}}{\text{Total Equity}} \quad (5)$$

To examine the effect of the mechanism of corporate governance and environmental performance on financial performance as measured by ROE, multiple regression analysis is conducted.

$$\text{ROE} = a + b_1 \text{MAN} + b_2 \text{INT} + b_3 \text{IND} + b_4 \text{AUD} + b_5 \text{PRO} + e \quad (6)$$

Where:

ROE = Financial performance (ROE)

a = Constants

b = Regression Coefficients

MAN = Managerial ownership

INT = Institutional ownership

IND = Proportion of independent commissioner

AUD = Audit committee

PRO = Environmental performance (PROPER)

e = Error

The descriptive statistical analysis is used to see an overview of the data that has been collected in this research. Classic assumption tests performed are normality test, multicollinearity test, heteroscedasticity test and autocorrelation test. To test the effect of the mechanism of corporate governance and environmental performance on ROE, the partial test or T-test, and F-test or simultaneous test is done. ROE is important as it focuses on the return to the shareholders of the company. Meanwhile, the partial test is implemented to determine the effect of each

independent variable on the dependent variable. Then, the simultaneous test is done to determine the effect of the independent variable simultaneously or together on the dependent variable.

## RESULTS AND DISCUSSIONS

This research uses a sample of manufacturing companies listed in Indonesia Stock Exchange that follows PROPER in the periods of 2012/2013 and 2013/2014. Table 1 shows the sample selection.

Table 1 Sample Selection Process

Manufacturing company listed in Indonesia Stock Exchange in 2014	145
Company's experience in relisting or delisting during the years 2012-2014	(14)
Company does not participate on PROPER 2012/2013 and 2013/2014	(84)
Company does not have a complete annual report and financial report	(7)
Financial report is not reported annually (12 months)	(1)
Company experience loss	(14)
Years of research	2
Samples obtained (25 X 2)	50

(Source: Data processed, 2015)

To get a good regression modeling, the research data must meet classical assumptions. The normality test is performed to ensure that the residuals of a distributed data examined are normal.

Table 2 Normality Test Result

Jarque-Bera	50,63258
Probability	0,000000

(Source: Result of histogram normality test performed by Eviews 9)

Based on the results in Table 2, the obtained probability value is equal to 0,000000 in which the rate is less than 0,05. Thus, it can be said that the data are not normally distributed. suggested that outlier is the data with unique characteristics and is very different from other observations that lead to an abnormally distributed data. Thus, the researcher excludes two companies from the sample so that the number of companies used as the sample is 23 companies. Moreover, with two years of total research, the number of samples is 46.

Table 3 Normality Test Result after Outliers Excluded

Jarque-Bera	2,474533
Probability	0,290176

(Source: Result of histogram normality test after the release of outliers performed by Eviews 9)

From the results in Table 3, the probability is 0,290176, and this value is greater than 0,05. Thus, it can be said that the data is normally distributed.

Table 4 Test Results of Multicollinearity Using Correlation Matrix

Correlation					
	MAN	INT	IND	AUD	PRO
MAN	1,000000	-0,228432	-0,114297	-0,091903	0,032670
INT	-0,228432	1,000000	-0,028928	-0,171068	0,122503
IND	-0,114297	-0,028928	1,000000	-0,220632	-0,116300
AUD	-0,091903	-0,171068	-0,220632	1,000000	0,145914
PRO	0,032670	0,122503	-0,116300	0,145914	1,000000

(Source: Result of multiple test performed by Eviews 9)

Moreover, from the results of the output in Table 4, there is no correlation value of more than 0,8. It can be said that there is no correlation between the independent variables in this research. In addition, research data is free from multicollinearity problems.

Then, based on the output values in Table 5, obtained Prob. F is equal to 0,5256. Compared to the alpha level of 0,05, the value of Prob. F is larger ( $0,5256 > 0,05$ ). Thus, there is no heteroscedasticity problem.

Table 5 Heteroscedasticity Test

F-Statistic	0,845831	Prob. F(5,40)	0,5256
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(Source: Result of Breusch-Pagan Godfrey test performed by Eviews 9)

Table 6 Autocorrelation Test

F-Statistic	1,686046	Prob. F(2,38)	0,1988
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(Source: Result of Breusch-Godfrey Serial Correlation LM Test performed by Eviews 9)

Based on the output value of F arithmetic is 0,1988 as seen in Table 6. That means this value is greater than the level of alpha 0,05 ( $0,1988 > 0,05$ ). Therefore, in this regression model, there is no autocorrelation.

The average (mean) count of each variable can be seen through the overview obtained from the descriptive statistics. It can also show the smallest value (minimum) and the largest value (maximum) of each of the variables tested in this research, such as managerial ownership (MAN), institutional ownership (INT), the proportion of independent commissioner (IND), the audit committee (AUD), environmental performance (PRO), and ROE. To find out how large a deviation of each variable is, it can be seen from the standard deviation of each of these variables presented in Table 7.



Furthermore, this research conducts multiple regression analysis to determine the effect of managerial ownership, institutional ownership, the proportion of independent commissioner, audit committee, and environmental performance on financial performance as measured by ROE as shown in Table 8.

Regression equation formed is as following:

$$\text{ROE} = 0,065902 - 0,040098 \text{ MAN} - 0,050068 \text{ INT} - 0,254530 \text{ IND} + 0,045453 \text{ AUD} + 0,009240 \text{ PRO} + e \quad (7)$$

Then, to find out how big a variation of the dependent variable is, it can be done by looking at the independent variables. Besides, testing the coefficient of determination has been done. Based on the output data of multiple regression analysis, the obtained regression coefficient has the value of 0,272957. It means that independent variables in this research can explain that the dependent variable is 27,29%. Meanwhile, the remain is equal to 72,71%, as affected by other independent variables that are not included in this research.

Independent variable of managerial ownership (MAN) has a significance value of 0,8766 which is considered greater than 0,05. Thus, Ha1 in this research is rejected. Hypothesis test results show that managerial ownership does not have a significant

effect on the financial performance of the company. The average ownership of managerial obtained in the research sample is very low at only 1,36%. Low stock ownership by management may be the cause of the lack of influence of managerial ownership on the financial performance of the company. Low stock holdings have not been able to drive optimal performance from the management. Therefore, the stock ownership by management has not been able to have a significant effect on the company's financial performance.

Independent variable of institutional ownership (INT) does not affect the company's financial performance. The significant value of the independent variable of institutional ownership (INT) is equal to 0,4259 that means it is greater than 0,05, so Ha2 rejected. Meanwhile, and Ho2 is accepted. This means that institutional ownership has no significant effect on the financial performance of the company. Institutional ownership possessed by the sample is large enough that it appears that the level of 72,48% institutional shareholding. Institutions as outside parties may not have been able to perform the function of optimal monitoring due to the lack of knowledge and information held by the institutions concerning the company's overall monitoring. Consequently, action can not be implemented on target effectively. In addition, the institution as an external party focuses more on short-term profits that have a tendency to be immediately pulled back its shares if the company is considered potentially less profitable for them.

Table 7 Statistics Descriptive Result

	MAN	INT	IND	AUD	PRO	ROE
Mean	0,013614	0,724858	0,371187	3,173913	2,956522	0,106169
Median	0,000157	0,764039	0,333333	3,000000	3,000000	0,092732
Maximum	0,178916	0,979605	0,500000	5,000000	5,000000	0,254117
Minmum	0,000000	0,436335	0,285714	2,000000	2,000000	0,005491
Std.Dev.	0,041606	0,173928	0,062348	0,643060	0,556038	0,075174

(Source: Result of statistics descriptive performed by Eviews 9)

Table 8 Multiple Regression Test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0,065902	0,119321	0,552311	0,5838
MAN	-0,040098	0,256679	-0,156217	0,8766
INT	-0,050068	0,062237	-0,804476	0,4259
IND	-0,254530	0,169632	-1,500482	0,1413
AUD	0,045453	0,016897	2,689968	0,0104
PRO	0,009240	0,018751	0,492789	0,6249
R-squared	0,272957	Mean dependent var		0,106169
Adjusted R-squared	0,182077	S.D. dependent var		0,075174
S.E. of regression	0,067986	Akaike info criterion		-2,417909
Sum squared resid	0,184886	Schwarz criterion		-2,179391
Log likelihood	61,61191	Hannan-Quinn criter.		-2,328559
F-statistic	3,003480	Durbin-Watson stat		1,416688
Prob (F-statistic)	0,021492			

(Source: Result of multiple regression analysis performed by Eviews 9)

Regression analysis shows that the proportion of independent commissioners (IND) has a significant value of 0,14113 which is greater than 0,05. Therefore  $H_{a3}$  is rejected and  $H_{o3}$  is accepted. This means that the proportion of independent commissioners does not have a significant effect on the financial performance of the company. The average proportion of independent commissioners possessed by the sample companies is 37,11% of the overall total commissioner. Although the number of Indonesia Stock Exchange's compliance with the regulations states that the minimum number of independent directors 30% of the total commissioners, it appears that this has not been able to guarantee the good performance of the company. Independent commissioner who is appointed by the company may only meet regulatory demands without considering the competence of the person. As a result, monitoring function could not be executed properly even though the regulations related to independent commissioner have been met. The ability and understanding of the independent commissioner of the company business will greatly influence the decisions made by an independent commissioner. Therefore, when an appointed independent commissioner is not competent, the monitoring function executed becomes ineffective. Louw (2011) found that in fact that many independent commissioners were not able to maintain their independence within the enterprise. This also may be a cause that there is no significant effect on the proportion of independent commissioner on the company's financial performance.

The regression results indicate that the hypothesis  $H_{a4}$  is accepted and  $H_{o4}$  is rejected, evidenced by the significant value of AUD below 0,05 which is 0,0104. This means that the audit committee has a significant impact on the financial performance of the company. The average number of audit committee owned by the sample companies is 3 where the number is already in accordance with the regulations set forth. Results of regression modeling of the audit committee in this research come out in a positive value (0,045453) so it can be interpreted that the audit committee has a positive influence on the financial performance of the company. The audit committee is a mechanism that can optimize the corporate governance oversight of the company's performance related to financial reporting, audit, risk management, and internal control. The results of this research prove that the audit committee owned by the sample companies does not only meet certain regulations but also has the competence and independence to carry out oversight of the implementation of the audit, financial reporting and risk management of companies to increase the confidence of investors and shareholders.

The regression results show the significant value of the variable PRO at 0,6249 that is greater than 0,05. Hence,  $H_{a5}$  is rejected and  $H_{o5}$  is accepted. It shows that environmental performance has no significant effect on the financial performance of the company. In this research, environmental performance is measured through the PROPER rating where the

average rating for the sample companies is 'Blue' rank. Companies with PROPER 'Blue' rating are a company that has been managing the environment in accordance with the minimum standards without doing environmental management that goes beyond those standards. Therefore, it is possibly considered that the company carries out environmental management as a formality in order not to be penalized as a result of poor environmental management. If the company does better environmental management and exceeds the standards set (environmental excellence), it will likely increase the company's image. Moreover, it may possibly be considered good by all stakeholders, including investors and consumers that the company's financial performance can be improved. In addition, PROPER may still not widely known by the public and investors that it becomes one of the causes of the lack of a significant effect on the environmental performance of the company's financial performance.

The value of F test at the regression results shows a significance value of 0,021492, which means less than 0,05. It can be said that simultaneously all independent variables in this research have a significant effect on the financial performance of the company.

## CONCLUSIONS

This research aims to determine whether the independent variables such as environmental performance and GCG mechanisms measured by managerial ownership, institutional ownership, the proportion of independent commissioners, and audit committee have an influence on the dependent variable, namely the company's financial performance as measured by ROE. The research is conducted on manufacturing companies that participates on PROPER 2012/2013 and 2013/2014. Moreover, samples are selected by purposive sampling with 50 samples.

From the analysis, managerial ownership has a significance value of 0,8766. It can be concluded that it does not affect the company's financial performance. Then, institutional ownership has a significance value of 0,4259, which is considered not to affect the company's financial performance. Next, the proportion of independent directors has a significance value of 0,14113. It can be considered that it does not affect the company's financial performance. Meanwhile, the audit committee has a significance value of 0,0104, so it can be concluded that it has significant influence on the company's financial performance. Last, environmental performance has a significance value of 0,6249, which can be concluded that it does not affect the company's financial performance.

This research is expected to provide an understanding of Good Corporate Governance and environmental performance, their influence on the company's financial performance, and additions to the literature. Suggestions to the next researchers are to

use a sample of companies from all industries that are listed in Indonesia Stock Exchange and to increase the number of periods so that research results can be more generalized. In addition companies are expected to continue improving and evaluating the quality of the audit committee to continue operating effectively so that the company's financial performance can be improved in accordance with what has been demonstrated in this research. Moreover, it also expects the investors to assess and consider the implementation of GCG and environmental management by a company before investing.

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